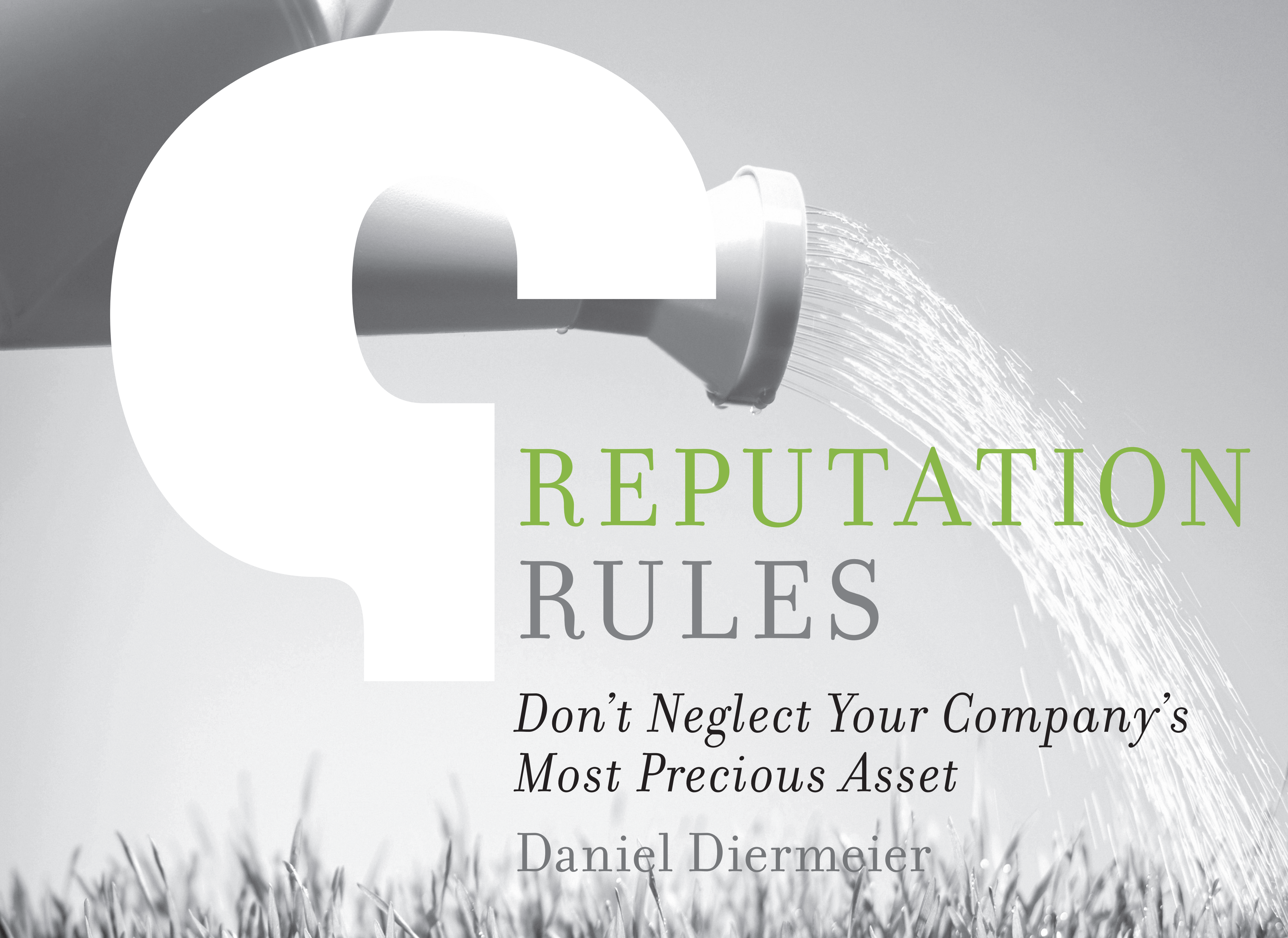

REPUTATION RULES

Don't Neglect Your Company's Most Precious Asset

Daniel Diermeier

CEOs and board members routinely list reputation as one the company's most valuable assets. Yet, every month a new reputational disaster makes the headlines, destroying shareholder value and trust with customers and other stakeholders. During the last year, leading companies ranging from Toyota, Goldman Sachs, BP to HP and Johnson & Johnson battled severe reputational crises. And we recently witnessed not only the devastating earthquake and Tsunami in Japan, but also the mostly futile response of Tepco, the nuclear operator of the Fukushima nuclear power plant.

While the sources of the crisis may vary from case to case and from industry to industry, in all cases financial markets punished the companies leading to a severe and sustained erosion of their market values. Often the loss of public trust is only the beginning of a company's troubles. Lawsuits, public hearings, and investigations soon follow. In some cases public officials may sense an opportunity to pursue policy agendas or occupy the role of heroes taking on corporate villains. In other cases, regulators and politicians may feel the pressure of the public to take decisive action changing competitive environments. In the case of nuclear power both the German and, to a lesser extent, Chinese governments quickly announced moratoriums on their nuclear power programs. In the German case the future of nuclear power seems to be doomed.

In every single case observers have pointed out specific mistakes by senior management and offered advice on how to avoid similar disasters. But it would be a mistake to just focus on the specific tactical mistakes in any given case and miss the broader trends that manifest themselves in ever more frequent and severe corporate crises.

Trust is now an essential part of business success. Yet trust in U.S. business has substantially dropped over the last decade. While trust in business is still higher in developing countries, Non-governmental organizations (NGOs) are on a par with businesses in emerging markets and more trusted in developed markets—including the United States. These data suggest that business can no longer rely on a trust reservoir. Rather, trust needs to be earned.

Companies have not responded to these changes. Their reputational risk has increased dramatically, but their capabilities have stayed the same. The result is one crisis chasing another and the long-term erosion of public trust in private enterprise.

Here is why reputational risk has increased. First: the public stage. Companies now operate in an ever-faster-moving news cycle, driven by intense competition between 24-hour news channels, wire services, and online news providers. Add to that the rise of user-generated content, from blogs to Twitter, Facebook and YouTube. Social media is not only a medium of sharing information and opinion quickly and permanently, as witnessed in the recent WikiLeaks campaign, they can also help diverse constituencies to better organize, as seen the critical role played by Facebook and Twitter in the Tunisian and Egyptian uprisings. These developments mean that companies have less and less control over their messages, shifting the balance of power from companies to customers and other stakeholders.

Second, the globalization of activist organizations and NGOs has matched the global reach of companies. Public institutions are no longer the sole source of constraints on commerce. Instead, political activists and NGOs have increasingly succeeded in forcing private regulation: the "voluntary" adoption of rules and standards that constrain certain forms of company conduct without the involvement of public agents. In many cases, the mechanism driving change is the creation of reputational crises for companies that, when effective, leave the companies with no choice but to change their business practices.

Third, the public (especially the younger public) expects more than growth and shareholder value. In the 2011 Edelman Trust Barometer, more than 85% of all respondents in the U.S. agreed with the statement: "Corporations need to create shareholder value in a way that aligns with society's interests, even if that means sacrificing shareholder value." The corresponding numbers in Germany were 91%, in the UK 89%, in China 89%, and in India 74%. Companies are responding to these concerns as witnessed by the explosive growth of corporate social responsibility reports, sustainability programs, and socially responsible investing. Some critics have dismissed these trends as passing fads that lack impact, but this assessment may be premature. In addition to typical business issues such as quality and product safety, reputational concerns are increasingly arising out of moral or ethical concerns. Child labor, dolphin-safe tuna, and shade-grown coffee are just some of the best-known examples.

Taken together, companies find themselves in an environment of higher expectations matched with higher scrutiny leading to higher reputational risk. But the risk is not matched by increased corporate capabilities. In other words, while reputational risks had risen significantly, reputation management capabilities have not kept up. But an increase in risk without a matching improvement in prevention and preparation capabilities will lead to more and more severe incidents.

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THE WRONG MINDSET

Surveys of board members and CEOs suggest that this message is finally sinking in. Corporate leaders understand the important of reputation, but are struggling with establish a process to manage reputational risk.

The problem begins with having the wrong mindset, as most companies view reputation as a corporate function, not a core capability. This attitude is based on the following beliefs:

1. A good reputation follows naturally from having good business practices and doing right by one's customers, employees, and suppliers.

2. If there is a problem, it can be safely delegated to Public Relations, Legal, or outside advisors.

3. Reputation management requires little else but common sense and the willingness to do the right thing.

Each one of these beliefs is flawed. First, the need to manage the organization's reputation actively is critical for any organization. Moreover, the importance of doing so is likely to increase, not decrease, in the near future. Of course, good business practices are important, even necessary, but they are not sufficient for successful reputation management.

Second, the responsibility for reputation management lies with business leaders, who cannot and should not simply delegate it to specialists such as lawyers or public relations experts. Although such experts can play a valuable role in the reputation management process, they should not own it. In most companies, if a reputation management process exists at all, it is typically located within the corporate communications department. If the company's reputation is truly one of its most precious assets, why delegate it to a department that all too often has insufficient funding and lacks influence over business decisions? Yet, most companies do precisely that. The operating word here is delegate. Communication will play an important role in any reputation management process, but such a process needs to be tightly integrated with the business. Reputation management should be the responsibility of the business leaders, led by the CEO as the steward of the corporate reputation.

An analogy with the "people" dimension can help make this point more clear. CEOs and general managers have learned over the last decade that they need to own the "people" process. Human Resources departments play a crucial role in the day-to-day management of people by enabling, implementing, and facilitating much of this process, but the business leader must own the process itself.

Good business practices are important, even necessary, but they are not sufficient for successful reputation management.

Challenges to a company's reputation typically arise out of a specific business context and thus require management and execution as an integral part of business decisions. This is critically important for the prevention of reputational crises, which can arise as a result of any business decision, whether it involves product design, marketing strategy, the pricing model, the compensation process, or even market entry or M&A activities. In many cases, the most effective way to manage reputational risk is to improve the capabilities of business leaders by helping them develop a sixth sense for reputational risks and opportunities (supported by well-designed processes) rather than adding another corporate layer.

Third, reputation management is difficult. It requires a high level of strategic sophistication and mental agility that sometimes runs counter to day-to-day business decisions.

A company's reputation is shaped not just by its direct business partners, customers, and suppliers, but also by external constituencies. Frequently, constituencies that have lain dormant for many years can suddenly spring into action, particularly in the case of reputational crises. They include not only the media, but also advocacy groups, influencers, regulators, and politicians.

A company's reputation consists of what others are saying about the company, and not just its business partners and customers. It is essentially public. Successful reputation management therefore requires the ability to assume external actors' perspectives and viewpoints. Many of these actors (although certainly not all of them) are motivated by moral or ideological concerns that the company or its managers do not share, and indeed may be openly hostile to the company's business practices. This often leads to a defensive, reactive posture on the part of business leaders, which may engender overly emotional reactions based on anger or self-pity.

A strategic approach requires the emotional fortitude to treat reputational difficulties as understandable and even predictable challenges that one should expect in today's business environment. As a result, companies should handle reputational crises like any other major business challenge: based on principled leadership and supported by sophisticated processes and capabilities that are integrated with the company's business strategy and culture.

Effective reputation management will always be challenging and, like any business skill, will require innovation and adaptation. However, appropriate capabilities can dramatically reduce the complexity of reputational challenges, help spot problems early, and assist in the development of effective strategies that are deeply integrated with the rest of the business.

TOWARDS A CAPABILITY

Reputational challenges can arise from any area of day-to-day decision making, but executives tend to make decisions without consideration for the reputational impact. The key skill for business leaders is the ability to maintain an external perspective throughout the decision-making processes and incorporate this perspective into the design of the business decision, e.g. the launch of a new product and its market-entry strategy. Companies need to understand that their decisions are creating a record today that will serve as the basis for their story tomorrow. Assessing reputational risk requires anticipating what a reputational crisis would look like and then taking proactive steps to prevent and prepare.

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Underneath these topics lurks a hard truth: most reputational challenges do not happen because of some external event or misfortune, but rather arise as the direct consequence of company actions. In other words, companies usually bear at least some responsibility for finding themselves in trouble. Why? Companies make decisions without considering the reputational impact of those decisions, so decision makers fail to act as the stewards of the company's reputation.

The following figure illustrates this point.

Figure 1: **Reputation Dynamics**

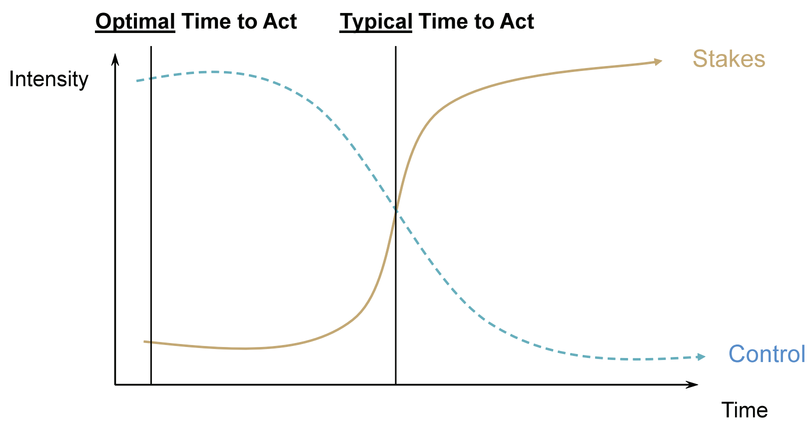


Figure 1 captures the difficulties that are inherent in reputation management, because it shows how control and impact move in opposite directions. During a reputational crisis, the stakes get higher as the company loses control. Customers and other stakeholders are paying attention, but the company must make decisions under extreme time pressure and with limited access to critical information. It is far better to manage one's reputation well in advance of a crisis, while the stakes are still low, the company retains substantial control, and time pressure is limited.

Companies must therefore recognize the reputational impact of any business decision before it is made whether they are related quality control (Toyota and Johnson & Johnson), safety (BP), product design and disclosure (Goldman Sachs), compensation (AIG), or executive conduct (HP). In all these cases, managers in departments ranging from HR to Engineering made decisions that had massive reputational consequences. Were these managers aware of these potential consequences? Did they act as guardians of the company's reputation, or did they merely focus on their narrow expertise and incentives? For most companies, the answer is the latter. Managers make decisions using all sorts of criteria, but the protection and enhancement of the company's reputation rarely receives more than lip service.

An easy way to improve decision-making processes is the Wall Street Journal test, which suggests that decision makers should ask themselves whether they would be proud if the decision were accurately reported on the front page of the Wall Street Journal. This test evocatively captures the idea that a decision may look different once it comes under public scrutiny. Strategic anticipation of reputational risk, however, goes beyond this simple approach by understanding the trade-offs between reputational risk and business opportunity.

The concept of reputation dynamics is the key to integrating reputational stewardship with everyday business decisions. It emphasizes the fact that a company's environment during a reputational crisis will look very different from its environment in normal times.

In the case of AIG's retention agreements, for example, a confidential contract between two parties faced sudden scrutiny in the glaring spotlight of 24-hour news coverage, simplified for a mass audience, with an emphasis on emotional impact and moral outrage. Advocacy groups that typically lie dormant or unorganized may jump on the stage, followed by politicians, regulators, and other officials.

The spotlight will focus not only on the company's current actions, such as how the CEO answers questions and what the company will do to fix the problem, but also on its past actions. Reporters will ask when the company first knew about the problem, or why management didn't do more to fix it. The thought process behind each past decision can be brought out into the public arena and questioned. These past actions and decisions are now part of the record and cannot be changed. Even those actions that looked reasonable at the time may wither under scrutiny from a hostile audience in a crisis context after their negative consequences come to light.

After the Gulf of Mexico oil spill, every minute decision that BP made concerning its safety processes took on disproportionate significance, leading to severe criticism of the company. And when Toyota had to recall its cars, commentators quickly alleged that its aggressive growth strategy had sacrificed quality and safety. The same is now happening in the context of the Fukushima nuclear power plant.

These considerations should also put to rest the misconception that reputation management can be left to specialists from the communication, legal, or compliance function. The key to successful reputation management is that all decision makers in the organization view themselves as stewards of the company's reputation. Proactive reputation management needs to anticipate the possibility of such developments and incorporate them into decision making. It requires a mindset that reflects an awareness that, through our business decision today, we are creating the facts that will be the basis for our story tomorrow. But mind-sets need to be supported by processes and culture.

THE CEO AS CRO

Who should own reputation management? Many executives answer: everyone. That sounds reasonable enough, but it is easy for things that are owned by everybody to actually be owned by nobody. Questions about decision rights, reporting, and accountability still need to be answered. Locating reputation management in the organizational structure of a company can be tricky, even for companies that "get it."

If reputation management is to become a functioning capability the answer is easy: the CEO is the company's Chief Reputation Officer.

The reason why reputation management belongs on the CEO's agenda is that not only is reputational risk one of the main risks facing the company, but the company's reputation is also one of the few sources of sustained competitive advantage. Companies with stellar reputations can charge premiums and are difficult to imitate.

One of the CEO's main tasks is to integrate reputation management into the operational processes of the business. One approach to accomplishing this task has been to create a separate corporate function: a chief reputation officer (CRO) or chief reputational risk officer (CRRO). This approach works only if the position carries weight and if the company can avoid creating yet another corporate officer with little budget and less influence. The danger in this approach is that it could create additional barriers to an integration of reputation management and business strategy and actually hurt the process rather than help it.

An alternative is the creation of a corporate reputation council (CRC). This is a cross-functional unit composed of senior executives with actual decision-making authority. It is critical that the CRC mirrors the actual operating structure of the business.

One of the reasons that Toyota was slow in responding to the 2010 sudden acceleration crisis was the lack of a truly global decision-making structure. While Toyota's economic fortunes were heavily dependent on robust U.S. sales, decision making was largely centered in Japan, with little input from the United States.

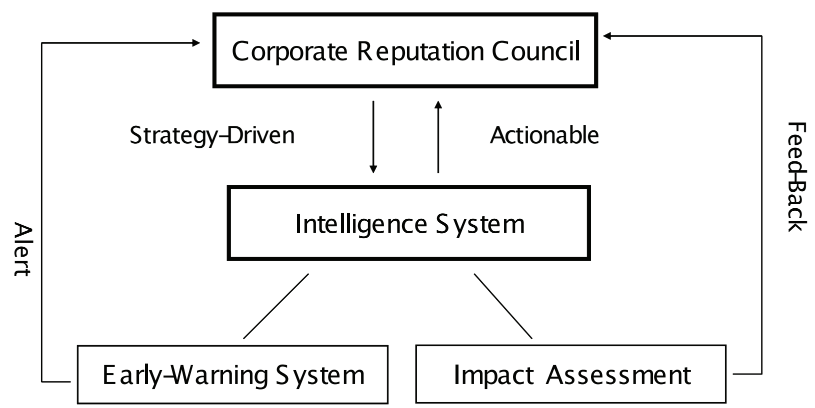
Good governance and decision-making structures are necessary for effective reputation management, but even these alone are not sufficient. Here is why:

- Reputation consists of the perceptions of customers and other constituencies.
- In many cases, these perceptions are derived not from actual experience with the company or a deep knowledge of any given issue, but from an ever-changing mixture of opinion and information driven by the media, peer-to-peer Web sites, and various influencers ranging from experts to advocacy groups.
- Proactive reputation management requires companies to identify issues early, connect them with the business strategy, develop prevention and preparation strategies, and implement possible changes in business practices in advance of an issue's gaining momentum.
- This sequence can break down at various points. Executives may not realize the importance of reputation management for business success, governance structures may be lacking, or incentive structures may reward short-term vision. But companies may also fail to adopt effective strategies simply because they are unaware of the imminent danger. In other words, even perfectly designed governance and decision-making structures will be ineffective if they lack critical intelligence: decisions are then made in the dark.

This is the business case for investing in intelligence capabilities. Because reputation is driven by many ever-changing actors, the strategic landscape is frequently diffuse and unclear. Because successful reputational strategies need to be designed before a crisis occurs, simply surveying customers, investors, or other business partners will not do. Once customers or investors start to worry, it is too late—the deck is already stacked against the company. Therefore, in many cases, traditional business research tools such as surveys and focus groups can only measure the damage rather than prevent it in the first place. Proactive reputation management is impossible without good intelligence.

Governance structure and intelligence capabilities need to be integrated. We call this integration the Reputation Management System. Figure 4 illustrates this integration.

Figure 4: **Reputation Management System**



The corporate reputation council (CRC) governs the Reputation Management System. It needs to represent the various business segments and critical corporate functions. Ideally, it should mirror the organizational structure of the company. In some businesses, it makes sense to extend the jurisdiction of the CRC to include regulatory and political developments as well as macroeconomic ones. In that case, it effectively becomes the corporate relations council.

The governance structure needs to be closely connected with the intelligence function. This means that the CRC provides strategic direction to the intelligence function and receives actionable intelligence that is directly connected to the corporate strategy. The intelligence function provides the core capabilities of issue identification, evaluation, and monitoring.

The goal is both to function as an early warning system and to be able to assess the impact of corporate actions through a feedback mechanism. Without an intelligence function, the CRC will be operating in the dark and making decisions based on intuition rather than data. A company's intelligence function may range from informal monitoring of various media sources and proactive stakeholder outreach to the creation of a fully developed internal intelligence capability with its own staff and budget.

Intelligence functions are not just important for management. Given the critical role of the board as a guardian of the company's reputation, it is surprising and worrisome that most corporate boards are not supported by a separate intelligence function. Such a function is ideally provided by a third party, not by company staff. Much of the critical reputational intelligence is external to the company, and it may lead board members to ask more probing questions of management.

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CULTURE

Business leaders also need to understand that even the most advanced reputation management system is implemented by people. They need to assess the situation, evaluate its risk and then make the appropriate decision. Getting this right requires not only a strategic mind-set but values and culture to provide guidance to individuals. We cannot expect each employee of a company to correctly assess the reputational risk of an issue, but we can expect him or her to raise a red flag when something does not "look right". It is here where the leadership of the company's CEO matters most.

Acting as corporate steward does not mean only doing right by customers, employees, and suppliers. It requires the ability to think strategically. This implies, on the one hand, viewing reputational decisions not solely as PR issues, but as decisions that are tightly connected to the company's strategy, its core competencies and values, and its distinctive position in the marketplace. On the other hand, it requires the ability to view even a familiar business decision from the point of view of people who are not specialists, but still may have strong opinions on an issue. More often than not, these opinions are not just driven by cool reason, but involve powerful emotions and passionate views of what is right or wrong behavior.

A strategic mindset also requires situational awareness. Reputation is essentially public. It is driven by third parties who have their own agenda. Understanding and anticipating the motivations and capabilities of these actors is essential for situational awareness. The Reputational Terrain provides such an orientation, whether we need to manage an ongoing issue or we want to assess the reputational risk associated with an important business decision. But reputational challenges are not simply the consequence of wrong decisions, accidents, or bad luck; they frequently are created by activists, interest groups, and public actors with the goal of forcing changes in business practices through "private politics." Activists are competitors for the company's reputation. They need to be treated as seriously as competitors in the marketplace.

The last component of a strategic mindset is to avoid the expert trap. Becoming an expert means learning to see the world in a particular way. A doctor learns to identify symptoms and decide on a diagnosis, a poker player learns to identify "tells" of opponents that provide critical information on the strength of their hand, and a music enthusiast can pick a pianist from dozens of recordings of the same piece. Acquiring and using expertise in a coordinated fashion is, of course, tremendously valuable and is at the root of the efficient organization of business processes. But in the context of reputational challenges, it can lead us astray.

When a company collapses as a result of an earnings restatement, a trained accountant may focus on the fact that no accounting rules were violated, while everybody else will be affected by images of crying employees leaving their office for the last time. A safety engineer will point to his company's industry-leading safety standards and may be bewildered when the media focus on one specific victim. A loan officer may view missed mortgage payments as lost revenue, while the borrower may experience them as the fear of losing the family home. The difficulty lies in the public nature of reputational challenges where company actions are evaluated by non-experts through the filter of the media. This requires decision-makers to set aside their expertise and see the situation from the point of view of laypeople in a heightened emotional state.

Reputation management is not a corporate function, but a capability. It requires the right mindset integrated with the company's strategy, guided by its culture and values, and supported by carefully designed governance and intelligence processes. Developing this capability is as demanding and as challenging as developing customer focus or the ability to execute. **Today's companies need to embrace this challenge.**

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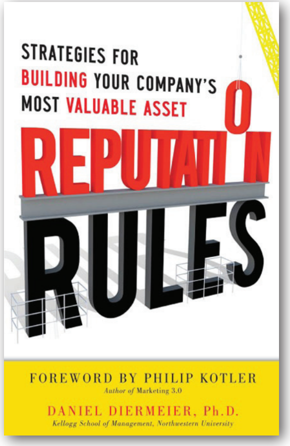

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